Internal Revenue Service

memorandum

CC:TL-N-783-86
Br1:LJack

date: 21 JAN 1986

to: District Counsel, Hartford NA:HAR

from: Acting Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your memorandum dated November 8, 1985 requesting technical advice with respect to the above-captioned case.

ISSUE

Whether a state court order reforming a grantor trust should be given retroactive effect for Federal tax purposes. RIRA Nos. 0677.03-00; 9111.15-02.

CONCLUSION

Even though the state court reformation is retroactive under state law and merely conforms the trust provisions with the settlor's true intent, the decree does not operate to retroactively excuse the trust of Federal income tax liability under I.R.C. § 677 for the years prior to the reformation.

DISCUSSION

FACTS:

According to your incoming memorandum, three brothers set up separate irrevocable trusts for the primary benefit of their children, and funded the trusts with their one-third (1/3) interest in certain real estate. Initially, each trust provided for the grantor's spouse as follows:

> It is further provided that if at any time in the absolute discretion of the Trustees, the Settlor's spouse's resources and income from outside sources of which the Trustees shall have knowledge, shall be insufficient in the discretion of the Trustees to provide for the Settlor's spouse's reasonable support, care, and comfort, or to pay the expenses of illness

> or accident, the Trustees may pay to or apply for the benefit of the Settlor's spouse so much of the principal or income as the Trustees may deem proper or necessary.

When the taxpayers were informed by an agent of the Internal Revenue Service that this provision caused the trusts to be grantor trusts, each grantor's spouse executed a disclaimer of her right to any trust principal or income during the grantor's lifetime.* Subsequently, the settlors and trustees brought a reformation action to add the words "after the Settlor's death" to each trust, thereby eliminating the spouses' access to trust funds during the lives of the grantors. The New Haven Superior Court agreed to the change by entry of a "Judgment in Accordance with Stipulation."

The settlors', their spouses, and the trustees all contend that the original purpose of the trusts was to provide for the settlors' children and only to consider the settlors' spouses after the death of the settlors. Affidavits have been presented from the attorneys who drafted the trusts stating that this was the grantors' original intent. The taxpayers' factual allegations are uncontradicted. Furthermore, it is presumed that the reformation was proper under state law and would be sustained by the Supreme Court of Connecticut.

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* Your incoming memorandum did not request advice about the effect of these disclaimers. It is our understanding, however, that you plan to take the position that the disclaimers were untimely for purposes of the 9-month rule in the Connecticut disclaimer statute. We agree that the disclaimers were untimely since they were executed more than two years after the creation of the trusts.

Law:

It is well established that a judicial reformation by a state court cannot change the Federal tax consequences of a completed transaction. American Nurseryman Publishing Co. v. Commissioner, 75 T.C. 271, 275 (1980), aff'd by order, (7th Cir. Nov. 23, 1981); Harris v. Commissioner, 461 F.2d 554, 556 n.2 (5th Cir. 1972), aff'g T.C.M. 1971-172; Van Den Wymelenberg v. United States, 397 F.2d 443, 445 (7th Cir. 1968); Emerson Institute v. United States, 356 F.2d 824 (D.C. Cir. 1966), cert. denied, 385 U.S. 822 (1966); Piel v. Commissioner, 340 F.2d 887 (2d Cir. 1965), aff'g T.C.M. 1963-346; Sinopoulo v. Jones, 154 F.2d 648 (10th Cir. 1946); Estate of Hill v. Commissioner, 64 T.C. 867 (1975), aff'd in an unpublished opinion, 568 F.2d 1365 (5th Cir. 1978); Davis v. Commissioner, 55 T.C. 416, 428 (1970); M. T. Straight Trust v. Commissioner, 24 T.C. 69 (1955), aff'd, 245 F.2d 327 (8th Cir. 1957); Van Vlaanderen v. Commissioner, 10 T.C. 706 (1948), aff'd, 175 F.2d 389 (3d Cir. 1949); Daine v. Commissioner, 9 T.C. 47 (1947), aff'd, 168 F.2d 449 (2d Cir.1948); Eisenberg v. Commissioner, 5 T.C. 856 (1945), aff'd, 161 F.2d 506 (3d Cir. 1947), cert. denied, 332 U.S. 767 (1947); but see Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964), rev'g 39 T.C. 52 (1952).

In this case, the state court reformation added the words "after the settlor's death" to each trust agreement in order to preclude the spouses from having access to the principal or income of the trusts during the lives of the settlors. Even if it is assumed that the quoted language was mistakenly omitted from the original trust agreements and that the settlors never intended for their spouses to have access to trust funds while the settlors were alive, the fact remains that:

> the reformation decree is not a determination of the legal effect of the original trust instrument under local law, nor does it purport to be such a determination. On the contrary, it alters and modifies the instrument. . . . Although this reformation may comply with the original intentions of the grantor as disclosed by his testimony and other evidence at the hearing in that proceeding, it is not an interpretation of the original instrument with in the principles of the cases above cited.

M. T. Straight Trust v. Commissioner, supra, 24 T.C. at 74. Accordingly, the state court's order may not be given retroactive effect. Id.

Thus, the present situation is distinguishable from cases in which a state court's construction of an instrument, while rendered subsequent to the taxable period in question, may be relied on to determine Federal tax consequences. In such cases, the state court is merely interpreting the rights of the parties under the instrument as it was originally drafted, and the Federal courts will give such adjudications varying degrees of deference under the doctrine of Commissioner v. Bosch, 387 U.S. 456 (1967).

The rationale for the rule that state court reformations do not change Federal tax consequences is that while parties to an instrument are bound by its reformation, third parties, such as the Commissioner, who have previously acquired rights under the instrument, are not bound by a reformation in which they did not participate. American Nurseryman Publishing Co. v. Commissioner, supra, 75 T.C. at 276; Fono v. Commissioner, 79 T.C. 680, 695 (1982).

In Van Den Wymelenberg v. United States, supra, the parties executed an amended trust agreement in 1963 to support their claim to a 1961 gift tax exclusion under section 2503(c). The Seventh Circuit stated as follows:

> Even assuming that the amended agreement expressed taxpayers intent at the time they executed the original agreement and that the discrepancy in that original agreement was caused by inadvertence, we hold the tax consequences must be determined by the original agreement.
>
> Taxpayers cite several Wisconsin state cases for the proposition that a written instrument which, through mistake, does not embody the intent of the parties may be reformed by the parties through voluntary execution of a corrected instrument. However, not even judicial reformation can operate to change the Federal tax consequences of a completed transaction (citations omitted).
>
> As to the parties to the reformed instrument, the reformation relates back to the date of the original instrument, but it does not affect the rights acquired by non-parties, including the Government. Were the law otherwise, there would exist considerable opportunity for "collusive" state court actions having the sole purpose of reducing Federal tax liabilities. Furthermore, Federal tax liabilities would remain unsettled for years after their assessment if state courts and private persons were empowered to retroactively affect the tax consequences of completed transactions and completed tax years.

397 F.2d at 444-5.

In a letter to District Counsel Attorney Robert Percy, dated September 23, 1985, petitioner's counsel cites a number of cases in support of the proposition that the state court reformation should be binding on the Tax Court. Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964), rev'g 39 T.C. 52 (1962), as discussed at length by petitioner's counsel, is admittedly contrary to our position. However, the Ninth Circuit appears to be alone in its position and its Flitcroft decision is followed by neither the Tax Court nor the other Federal circuit courts. Moreover, the instant case is not appealable to the Ninth Circuit.

The two Third Circuit cases cited by petitioner, Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955) and Estate of Darlington v. Commissioner, 62-1 U.S.T.C. 12,075 (3d Cir. 1962), are both distinguishable. They involved the Federal tax effect of state court adjudications which merely determined the property rights of the parties under local law. This Bosch issue is not present in the instant case because, as pointed out above, this reformation amended the trust rather than merely declaring the rights of the parties under the original agreement. Cf. Van Vlaanderen v. Commissioner, supra, 175 F.2d 389, 390 (3d Cir. 1949).

Vargason v. Commissioner, 22 T.C. 100 (1954), acq. 1968-2 C.B. 3, and Newman v. Commissioner, 68 T.C. 494 (1977) are likewise distinguishable in that each involved the correction of a court order, rather than a change in the status of the parties as it existed in prior years. The Tax Court gave effect to subsequent divorce decrees issued "to conform the original decree to what was the intention of the court at that time (emphasis added)." While the holding in cases like Vargason is questionable, it is noted that an order purporting to correct a mistake of the court is less subject to collusion than an order purporting to correct a mistake of the parties. Moreover, the Tax Court seems to have limited the doctrine of these cases to the divorce decree context, where the high degree of judicial scrutiny protects against collusion by the parties and where retroactivity effectuates the statutory policy underlying section 71 of taxing the spouse who actually receives the income. See 68 T.C. at 503. See also Rev. Rul. 71-416, 1971-2 C.B. 83, holding that a nunc pro tunc order correcting a mathematical error in the original divorce decree should be given retroactive effect for Federal tax purposes.

Lebeau v. Commissioner, T.C.M. 1980-201, is distinguishable in that it involved giving Federal tax effect to a state court amendatory order which "merely clarified" a pre-existing settlement agreement. In the case at hand, the reformation

significantly amended the trust and altered the rights of the parties, rather than merely clarifying what their rights were under the original trust instruments.

Based on the foregoing, we recommend that the instant case be defended.

MARLENE GROSS

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